

13-1337

TAX TYPE: INCOME TAX

TAX YEARS: 2005, 2006, and 2007

DATE SIGNED: 6-10-14

COMMISSIONERS: B. JOHNSON, M. CRAGUN, R. PERO

EXCUSED: D. DIXON

GUIDING DECISION

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BEFORE THE UTAH STATE TAX COMMISSION

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TAXPAYER-1 and TAXPAYER-2,

Petitioners,

vs.

AUDITING DIVISION OF THE UTAH  
STATE TAX COMMISSION,

Respondent.

**INITIAL HEARING ORDER**

Appeal No. 13-1337

Account No. #####

Tax Type: Income Tax

Tax Years: 2005, 2006 and 2007

Judge: Phan

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**Presiding:**

Jane Phan, Administrative Law Judge

**Appearances:**

For Petitioner: TAXPAYER-1, By Telephone

For Respondent: REPRESENTATIVE FOR RESPONDENT, Assistant Attorney

General

RESPONDENT-1, Manager, Income Tax Auditing

RESPONDENT-2, Senior Auditor

**STATEMENT OF THE CASE**

This matter came before the Utah State Tax Commission on February 18, 2014, for an Initial Hearing in accordance with Utah Code §59-1-502.5. Petitioners (Taxpayers) are appealing an audit deficiency of additional Utah individual income tax, penalties and interest for the tax years 2005, 2006 and 2007. The Taxpayers had not filed Utah Nonresident Individual Income Tax Returns for each of the years at issue. The audits were issued by Respondent (Division) based on the Taxpayers' status as nonresidents with Utah source income. The Notices of Deficiency and Estimated Income Tax were issued on April 10, 2013, for each of the years at issue. Interest and 10% failure to file, 10% failure to pay penalties were assessed for each of the years. The amount of the deficiency for each audit year is as follows:

| Year | Tax        | Interest <sup>1</sup> | Penalties  | Total as of Date of Notice |
|------|------------|-----------------------|------------|----------------------------|
| 2005 | \$\$\$\$\$ | \$\$\$\$\$            | \$\$\$\$\$ | \$\$\$\$\$                 |
| 2006 | \$\$\$\$\$ | \$\$\$\$\$            | \$\$\$\$\$ | \$\$\$\$\$                 |
| 2007 | \$\$\$\$\$ | \$\$\$\$\$            | \$\$\$\$\$ | \$\$\$\$\$                 |

#### APPLICABLE LAW

Except as provided in Subsection (3), a tax is imposed on a nonresident individual in an amount equal to the product of the nonresident individual's (a) unapportioned state tax; and (b) state income tax percentage.  
(Utah Code §59-10-116(2)(2006).)<sup>2</sup>

(1)For the purpose of Section 59-10-116, federal adjusted gross income derived from Utah sources shall include those items includable in federal "adjusted gross income" (as defined by Section 62 of the Internal Revenue Code) attributable to or resulting from: . . . (b) the carrying on of a business, trade, profession, or occupation in this state.

(2)For the purposes of Subsection (1): (a) Income from intangible personal property, including annuities, dividends, interest, and gains from the disposition of intangible personal property shall constitute income derived from Utah sources only to the extent that such income is from property employed in a trade, business, profession, or occupation carried on in this state. . . . (g) A nonresident partner's distributive share of partnership income, gain, loss, and deduction derived from or connected with Utah sources shall be determined under Section 59-10-303.

(Utah Code §59-10-117(2006).)

In determining the adjusted gross income of a nonresident partner of any partnership, there shall be included only that part derived from or connected with sources in this state of the partner's distributive share of items of partnership income, gain, loss, and deduction entering into his federal adjusted gross income, as such part is determined under rules prescribed by the commission in accordance with the general rules in Section 59-10-116.

(Utah Code §59-10-303(1)(2006).)

A partnership is not subject to the tax imposed by this chapter. Persons carrying on business as partners are liable for the tax imposed by this chapter only in their separate or individual capacities.

(Utah Code §59-10-301(2006).)

Each item of partnership income, gain, loss or deduction has the same character for a partner under this chapter as it has for federal income tax purposes. When an item is not characterized for federal income tax purposes, it has the same character for a partner as if realized direct from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.  
(Utah Code §59-10-302(2006).)

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<sup>1</sup> Interest continues to accrue on the deficiency until paid in full.

<sup>2</sup> For convenience the Commission lists the laws in affect during the 2006 tax year. There were some amendments or revisions to the Individual Income Tax Act during the audit years, but the substantive law at issue in this appeal was the same for all three years.

In determining the sources of a nonresident partner's income, no effect shall be given to a provision in the partnership agreement which: (a) characterized payments to the partner, as being for services or for the use of capital, or allocates to the partner, as income or gain from sources outside this state, a greater proportion of his distributive share of partnership income or gain than the ratio of partnership income or gain from sources outside this state to a partnership income or gain from all sources, except as authorized in Subsection (4).

(Utah Code §59-10-303(2)(2006).)

For purposes of taxation under this title, a limited liability company or a foreign limited liability company transacting business in the state shall be classified in the same manner as it is classified for federal income tax purposes.

(Utah Code §59-10-801(2006).)

The Commission has adopted an Administrative Rule regarding partnership income as follows:

- (1) Every partnership having a nonresident partner and income derived from sources in this state shall file a return in accordance with forms and instructions provided by the Tax Commission.
- (2) If the partnership has income derived from or connected with sources both inside and outside Utah and if any partner was not a resident of Utah, the portion derived from or connected with sources in this state must be determined and shown.
  - (a) The Utah portion must be determined and shown for each item of the partnership's, and each nonresident partner's, distributive shares of income, credits, deductions, etc., shown on Schedules K and K-1 of the federal return.
  - (b) The Utah portion may be shown: (i) alongside the total for each item on the federal schedules K and K-1; or (ii) on an attachment to the Utah return.

. . . (Utah Admin. Rule R865-9I-21.)

Utah Code §59-1-1417 provides, “[i]n a proceeding before the commission, the burden of proof is on the petitioner...”

The Commission has been granted the discretion to waive penalties and interest. Utah Code §59-1-401(13) provides, “Upon making a record of its actions, and upon reasonable cause shown, the commission may waive, reduce, or compromise any of the penalties or interest imposed under this part.”

The Commission has promulgated Administrative Rule R861-1A-42 to provide additional guidance on the waiver of penalties and interest, as follows in pertinent part:

- (2) Reasonable Cause for Waiver of Interest. Grounds for waiving interest are more stringent than for penalty. To be granted a waiver of interest, the taxpayer must prove that the commission gave the taxpayer erroneous information or took inappropriate action that contributed to the error.

- (3) Reasonable Cause for Waiver of Penalty. The following clearly documented circumstances may constitute reasonable cause for a waiver of penalty:
- (a) Timely Mailing...
  - (b) Wrong Filing Place...
  - (c) Death or Serious Illness...
  - (d) Unavoidable Absence...
  - (e) Disaster Relief...
  - (f) Reliance on Erroneous Tax Commission Information...
  - (g) Tax Commission Office Visit...
  - (h) Unobtainable Records...
  - (i) Reliance on Competent Tax Advisor...
  - (j) First Time Filer...
  - (k) Bank Error...
  - (l) Compliance History...
  - (m) Employee Embezzlement...
  - (n) Recent Tax Law Change...

### DISCUSSION

The Taxpayers were residents of STATE and not residents of Utah during the audit years. Although income had been reported to the Taxpayers from BUSINESS-1, (BUSINESS-1) it was the Taxpayers' position that this income was investment income or specifically interest income from a loan and taxable only to the Taxpayers' state of domicile, STATE. The Taxpayer explained that BUSINESS-1 had been set up solely to provide a loan to BUSINESS-2, and essentially it was the payments on this loan that were the income being taxed by the Division in the audit. It was the Division's position, however, that the income was Utah source income reported on a K-1 as income to the Taxpayer from a Utah limited liability company and had been claimed by the Taxpayers as pass through income on their individual federal returns.

The Taxpayer, TAXPAYER, was a limited partner or non-managing member in BUSINESS-1 with a 4% interest.<sup>3</sup> BUSINESS-1 was a Utah limited liability company and it had filed a Utah Partnership/Limited Liability Partnership/Limited Liability Company Return of Income (TC-65) in Utah for each of the audit years.<sup>4</sup> The TC-65 confirmed that BUSINESS-1'S income was solely interest income, which confirmed the Taxpayer's assertion that it had been set up for purposes of providing a loan. For each year the TC-65 filed by BUSINESS-1 indicated 100% of its income was apportioned to Utah.<sup>5</sup> BUSINESS-1 reported the Taxpayers' share of this income as pass through income with a Schedule K-1 Filing to the IRS. For the 2005 tax year the amount of income reported to the Taxpayers had been \$\$\$\$.<sup>6</sup> Similar amounts were reported

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<sup>3</sup> See Exhibit AUD. 000063.

<sup>4</sup> The Division provided copies of these returns for each year at issue as Exhibits.

<sup>5</sup> For the 2005 year, see AUD. 000041, line 22 on the TC-65.

<sup>6</sup> See Federal Transcript for the 2005 tax year, AUD. 000027.

to the Taxpayers for 2006 and 2007. The Taxpayers included these amounts on their joint filed federal Form 1040 return on Line 8a-Taxable interest.

The Division argues in this appeal that the income at issue from BUSINESS-1 was treated as if it was Utah partnership income and as pass through income to the Taxpayer. This income was not taxed at the limited liability level. BUSINESS-1'S TC-65 reports all the income as Utah source income. This income flowed through and was taxed on the Taxpayers' individual income tax returns. Under Utah Code Sec. 59-10-801 the limited liability company is classified in the same manner as on the federal return. In the Taxpayers' case the income was treated as Utah pass through income or partnership income as reported on a K-1 to the IRS. Under Utah Code Sec. 59-10-301, it is the partner, not the partnership that is subject to tax and under 59-10-302 each item has the same character for the partnership as on the federal return.

The Taxpayers argue that this is investment or interest income that can only be taxed to their state of domicile. However, the question in this appeal is whether the income is attributable or resulting from BUSINESS-1'S carrying on of a business in Utah under Utah Code Sec. 59-10-117. There clearly could be situations where interest income did not result from the carrying on of a business, but in this case the Taxpayer states the only purpose for establishing the entity BUSINESS-1 was to make the loan to BUSINESS-2. BUSINESS-1'S tax filings show that the only income received was interest income. Therefore, it appears there was no other business activity for BUSINESS-1 than the loan. The way the transaction was structured this occurred in Utah and BUSINESS-1 sourced the income 100% to Utah. The Taxpayers' position is not supported by the provisions in the statute given the manner in which this transaction was structured with the income reported to the Taxpayers being from a Utah limited liability company's business income. In fact, the Taxpayers do not cite to any statutory provision or case law in support of their position.

The Division did assess failure to file and failure to pay penalties against the Taxpayers for each of the years at issue. The Commission may waive penalties based on Utah Code Sec. 59-1-401(13) for reasonable cause. The Commission has in prior decisions waived penalties for nonresident individuals who had Utah filing requirements due to having received Utah source income, as this is a first time filing situation and is a difficult area of law. The penalties should be waived in this matter for all three of the audit years.

There are different criteria for waiving interest. Under Utah Admin. Rule R861-1A-42(2), interest is waived if a taxpayer proves that the Tax Commission gave the taxpayer erroneous information or took inappropriate action that contributed to the error. The Taxpayers did not

provide a basis for waiver of interest at this hearing. The audit deficiencies for each year as to tax and interest should be sustained. The penalties should be waived.

Jane Phan  
Administrative Law Judge

DECISION AND ORDER

Based on the forging, the Tax Commission sustains the individual income tax audits against the Taxpayers for the years 2005 through 2007, as to tax and the interest accrued thereon. The Commission waives the penalties for all three audit years. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission  
Appeals Division  
210 North 1950 West  
Salt Lake City, Utah 84134

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 2014.

R. Bruce Johnson  
Commission Chair

D'Arcy Dixon Pignanelli  
Commissioner

Michael J. Cragun  
Commissioner

Robert P. Pero  
Commissioner

**Notice of Payment Requirement: Any balance due as a result of this order must be paid within thirty (30) days of the date of this order, or a late payment penalty could be applied.**

